

**BEFORE THE TAX COMMISSION OF THE STATE OF IDAHO**

|                                 |   |                  |
|---------------------------------|---|------------------|
| In the Matter of the Protest of | ) |                  |
|                                 | ) | DOCKET NO. 15788 |
| [Redacted]                      | ) |                  |
| Petitioners.                    | ) | DECISION         |
|                                 | ) |                  |
| _____                           | ) |                  |

On April 13, 2001, the Income Tax Audit Bureau of the Idaho State Tax Commission issued a Notice of Deficiency Determination (NOD) to [Redacted] (taxpayers) proposing deficiencies in income tax, penalty, and interest for the periods ending 12/31/95, 12/31/96, 12/31/97, 12/31/98, and 12/31/99 in the total amount of \$3,402.

On June 15, 2001, a timely protest and petition for redetermination was filed by the taxpayers. An informal conference was requested by the taxpayers and held on January 8, 2002, to discuss the issue that is the subject of this decision. A second informal conference was held on July 2, 2002 to discuss and document separate issues, as to which the auditor and the Tax Commission now agree with the taxpayers, and which issues are therefore no longer in dispute. The Tax Commission has reviewed the file, is advised of its contents, and hereby issues its decision MODIFYING the deficiency determination.

The issue for decision is the treatment of a lease from a railroad to [Redacted] that was assigned to the buyer of all of [Redacted] assets in the year ending 12/31/1997. An issue concerning the taxpayers' eligibility for an Idaho capital gain deduction has been withdrawn by the taxpayers' representative.

**Facts**

The taxpayers are farmers and were shareholders of [REDACTED], an S corporation [Redacted] owned and operated a facility for loading and unloading grain from an

adjacent railroad. The facility consists of owned real estate, land leased from the railroad, an elevator, bins, scales, a railroad spur, a seed plant, and “legs” to load and unload grain.

The competitive advantage of the facility, compared to others in the area, is that it is adjacent to the railroad and sits partly on property owned by the railroad. This situation allows the facility to load trains of 50 or more cars rapidly; trains of that length receive preferential freight rates from the railroad. It also allows the trains to unload directly into a pit under the rail spur and allows movement of grain from the pit via conveyors into the bins, instead of using an auger under the cars to move the grain into trucks.

The railroad leased two parcels of its land to [Redacted] and another parcel at [Redacted]. The leases provide for a perpetual term and annual rent that is renegotiated every five years.

In the tax year ending 12/31/1997, [REDACTED] sold its assets to a third party buyer for \$3,800,000. Section 1.01 of the sales contract provided that the sales price would be allocated as follows: \$150,000 to equipment; \$1,000,000 to goodwill; and \$2,650,000 to real property. The railroad leases were assigned in Section 1.02 of the contract, and no consideration was allocated there to the railroad leases. The leases were assigned in a separate document to the buyer at the same time as the sale of assets.

The Tax Commission’s auditor contacted the buyer of the business. The buyer allocated its purchase price as was done in Section 1.01 of the contract. The buyer allocated no purchase price to the railroad leases.

The tax law provides for recapture of depreciation when depreciable assets are sold. To compute recapture on buildings, grain bins, the rail spur, and track scales, the Tax Commission’s auditor took the \$2,650,000 and further allocated it among those assets and land, which is not depreciable. The auditor first used the assessed values of the land, buildings, grain bins, rail spur

and track scales as found in county property tax records for 1996, coming to a total for those assets of \$853,134. The remaining sales price of \$1,796,866 was prorated to those same assets based on their relative fair market values. The end result was an allocation to land and buildings of \$370,469, and an allocation to grain bins, rail spur and track scales of \$2,279,531.

Of the last amount, the taxpayers contend that \$719,531 should be allocated to the railroad leases and hence not be subject to recapture. They compute this amount by assigning a lower value to the grain bins, based on the cost of their replacement plus their book value, for a total allocation to the grain bins of \$1,560,000 which, when subtracted from \$2,279,531, leaves \$719,531 for the leases.

The Tax Commission did not receive an original 1999 tax return from the taxpayers. The auditor based the audit on a copy of the taxpayers' 1999 tax return provided by the taxpayer's representative. The representative was the paid preparer of the 1999 return. He stated that the taxpayers, after signing the return, brought it back to his office for mailing, and that he placed the return timely in his office's outgoing U.S. mail. No other evidence of timely mailing has been provided.

### **Law and analysis**

The tax law treats a sale of a business as a sale of each individual asset, rather than as a sale of a single asset. *E.g., Williams v. McGowan*, 152 F.2d 570 (2d Cir. 1945). The seller must allocate the purchase price among the various assets to determine the amount realized from their respective sales and the amount and character of the resulting gain(s) and/or loss(es).

Internal Revenue Code (IRC) § 1060 requires both the seller and purchaser to use the residual method of valuation, which treats a payment in excess of the value of purchased tangible

assets as a payment for goodwill, without requiring a separate determination of the value of goodwill.

Section 1060(a) provides that a written allocation agreement between the parties is binding on both parties, unless the Internal Revenue Service finds that such an allocation is inappropriate. According to the 1990 House Report on the amendment of § 1060(a), a party may challenge the allocation agreement only for mistake, undue influence, fraud, or duress. H.R. Rep. No. 201, 101<sup>st</sup> Cong., 2d Sess. 100, 102 (1990).

Here, the sales contract allocated all of the sales price to equipment, goodwill, and real property, and allocated nothing to the railroad leases. The leases were assigned under a paragraph co-equal with the paragraph that allocated the sales price to other assets. The existence of the lease paragraph negates any argument that the leases might have been considered by the parties to be real property, to which some consideration was intended to be allocated. *Cf. Mitchell v. Commissioner*, 42 T.C. 953 (1964)(acq.), in which the IRS's attempt to allocate some consideration to a 98-year sublease of a 99-year lease held by the sellers of a motel, instead of entirely to the motel and its furniture and fixtures, was struck down. The Court found that the sales contract assigned zero consideration to the subleases.

As the taxpayers have not alleged any mistake, undue influence, fraud, or duress to override the effect of the contracted allocation, § 1060(a) requires that the contractual allocation of zero proceeds to the railroad leases be sustained.

A penalty for late filing of the 1999 return is affirmed.

### **Conclusion**

WHEREFORE, the Notice of Deficiency Determination dated April 13, 2001, is hereby MODIFIED, and as so modified, it is hereby AFFIRMED and MADE FINAL.

IT IS ORDERED and THIS DOES ORDER that the taxpayers pay the following tax and interest (computed through 12/31/2002)(interest runs at \$.12 per day):

| <u>YEAR</u> | <u>TAX</u> | <u>PENALTY</u> | <u>INTEREST</u> | <u>TOTAL</u>  |
|-------------|------------|----------------|-----------------|---------------|
| 12/31/1995  | \$(5,629)  | 0              | \$(1,688)       | \$(7,317)     |
| 12/31/1996  | \$(4,604)  | 0              | \$(1,380)       | \$(5,984)     |
| 12/31/1997  | 4,095      | 0              | 1,463           | 5,558         |
| 12/31/1998  | 0          | 0              | 0               | 0             |
| 12/31/1999  | 5,899      | 1,475          | 1,222           | <u>8,596</u>  |
|             |            |                |                 | <u>\$ 853</u> |

DEMAND for immediate payment of the foregoing amount is hereby made and given.

An explanation of the taxpayers' right to appeal this decision is enclosed with this decision.

DATED this \_\_\_\_ day of \_\_\_\_\_, 2002.

IDAHO STATE TAX COMMISSION

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COMMISSIONER

### **CERTIFICATE OF SERVICE**

I hereby certify that on this \_\_\_\_ day of \_\_\_\_\_, 2002, a copy of the within and foregoing DECISION was served by sending the same by United States mail, postage prepaid, in an envelope addressed to:

[Redacted]

[Redacted]